92D CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
1st Session } { No. 92–508

INCORPORATING PROFESSIONS IN THE DISTRICT OF COLUMBIA

SEPTEMBER 23, 1971.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

MR. MCMILLAN, from the Committee on the District of Columbia, submitted the following

REPORT

[To accompany H.R. 10383]

The Committee on the District of Columbia to whom was referred the bill (H.R. 10383) to enable professional individuals and firms in the District of Columbia to obtain the benefits of corporate organization, and to make corresponding changes in the District of Columbia Income and Franchise Tax Act, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE OF THE BILL

The purpose of this bill (H.R. 10383) is to authorize individuals in the District of Columbia rendering professional services which under existing law, custom, or standards of professional conduct of practice, may not be rendered through a corporate structure, including without limitation, services performed by certified public accountants, attorneys, architects, physicians, dentists, optometrists, podiatrists and professional engineers, to join in the formation of a corporation.

The bill does not require professionals to incorporate. It simply provides them with the opportunity to incorporate and defines the structure which results from that incorporation.

Your Committee believes that professionals in the District of Columbia should be given the privilege now accorded to all businessmen; namely, the right to incorporate.

Professionals are now authorized to incorporate in every state of these United States. Though the encouragement of doctors, dentists, lawyers, architects, accountants, engineers and other professionals, all the 50 state legislative bodies have adopted legislation authorizing the incorporation of such professionals. Prior to this authorization, professionals had to resort to partnerships as their vehicles of combina-

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tion. In a number of respects, partnerships, as compared to corporations are ungainly and complicated.

ADVANTAGES OF INCORPORATION

Several basic attributes of professional corporations give them value over a partnership structure. A corporation has a greater degree of centralization of management. A corporation limits the liability of a stockholder when an officer of the corporation properly acts within the authority given him by the Board of Directors. (However, in a professional corporation the professional still bears the responsibility for his own malpractice.) A professional corporation has perpetual existence; whereas, a partnership comes to an end upon the death of any partner. Finally, a professional corporation has greater flexibility with respect to transfer of interests than does a partnership.

As a general matter, the laws regarding corporations are much more clearly defined than as to the partnerships. The guidelines for corporate activities, responsibilities, and relationships are well-known. Partnership agreements by necessity become long and cumbersome because the partners are unable to resort to the large body of statutory and case law which define the corporate concept.

THE DISTRICT OF COLUMBIA AND FEDERAL TAX CONSIDERATIONS

There are a number of tax advantages under Federal tax laws to professional individuals operating in the corporate form. Probably the most significant advantages at the present time stem from the disparities in the Federal tax treatments of qualified retirement plans of corporate employees and of qualified retirement plans for self-employed individuals. Broadly speaking, the Federal income tax treatment of all such qualified plans consists of a deferral of the Federal income tax with respect to contributions made on behalf of employees, including self-employed individuals, until distribution of the employees' benefits and the deferral, for the same period, of the Federal income tax on the earnings from investment of all contributions made under the plan.

As indicated above, the benefits under qualified retirement plans for self-employed individuals, or so-called "H.R. 10 plans", are not nearly so broad as those under corporate plans. One of the most significant differences concerns the maximum limitation on contributions on behalf of self-employed individuals who have a more than 10% interest in the business (so-called "owner-employees"). Under the Federal Internal Revenue Code, such contributions are limited to the *lesser* of 10% of the individual's "earned income" from the business or $2,500 per year. On the other hand, in the case of corporate retirement plans, contributions up to 25% of an employee's compensation are permitted where the employer has both a pension plan and a profit sharing plan and there is no ceiling on the dollar amount which may be contributed. Similarly, the benefits from voluntary additional contributions, i.e., the contributions by the employee or by self-employed individuals for which no deduction is allowable, are greater under corporate retirement plans. Specifically, under corporate plans an employee may contribute up to 10% of his compensation without regard to the dollar

amount thereof, with the result that such contributions will then accumulate tax-free income until the distribution of the employee's benefits upon his retirement. On the other hand, voluntary contributions by "owner-employees" are restricted to the *lesser* of 10% of earned income from the business or $2,500 per year *and* may only be made if there are plan participants during the tax year other than "owner-employees" who are permitted to make voluntary contributions. In addition, there are requirements with respect to the qualification of plans which include self-employed individuals which are not imposed with respect to corporate plans and these are particularly onerous in the case of plans which include self-employed individuals who are "owner-employees".

Another benefit which is available to corporate employees which is not available to self-employed individuals is the opportunity to receive one's account entirely in the year of retirement and have a portion thereof taxed at capital gains rate. A lump-sum distribution to a self-employed individual is taxable ordinary income, subject to a special averaging rule in certain cases.

Lastly, the present Federal estate tax and gift tax exclusions available with respect to contributions to qualified retirement plans by corporate employers are not available with respect to contributions under H.R. 10 plans.

OTHER TAX BENEFITS

In addition to benefits relating to qualified retirement plans discussed above corporate employees also have available many other Federal income tax benefits which their self-employed counterparts do not enjoy. A corporate employer may provide group term life insurance coverage for its employees, tax-free, up to a maximum of $50,000 coverage. In addition, corporate employers may, depending upon the coverage limitations of the particular local jurisdiction, provide additional group term life insurance coverage for its employees at a very nominal Federal tax cost.

Corporate employees may receive the benefit of payments from accident, health and sickness insurance plans and from medical and dental reimbursements plans tax-free. At the same time the corporate employer is entitled to a deduction for the insurance premiums paid and for the medical and dental reimbursements, as the case may be.

Corporate employees are also eligible to exclude a portion of their salaries which are paid to them under so-called wage continuation or sick pay plans while they are away from work on account of personal injuries or sickness.

Corporate employers may pay death benefits to beneficiaries of their employees up to a maximum of $5,000 without any tax resulting to the recipient. In addition, a corporate employer may make a nondeductible tax-free gift to the widow of a deceased employee in appropriate circumstances.

And finally, two fairly insignificant tax advantages might be mentioned. First, the first $25,000 of a corporation's taxable income is subject to the 22% normal tax rate and the excess is presently subject to a 48% rate. Second, a corporation has a completely free choice of a fiscal year for Federal tax reporting purposes, whereas a partnership must adopt the same taxable year as its partners.

AMENDMENT TO THE DISTRICT OF COLUMBIA INCOME AND FRANCHISE TAX ACT OF 1947

Section 21 of the bill amends the District of Columbia Income and Franchise Tax Act of 1947 (D.C. Code, tit. 47, sec. 1574) in order to maintain for unincorporated professional associations the unincorporated business tax exemption which these asociations presently have under that Act.

All the representatives of the various groups testifying in support of the bill stated that they consider this section to be an essential part of the bill and that they would not support it without this section.

Representatives of the Bar Association, for example, stated they have opposed previous attempts to repeal this exemption on essentially two grounds. First, both the States of Maryland and Virginia grant a credit to their residents for income taxes paid to another jurisdiction on income generated in that jurisdiction. The District unincorporated business tax does not qualify for this credit since it is a franchise tax rather than an income tax. Accordingly, the professional who resides in Maryland or Virginia and conducts his practice in the District would, if his present tax exemption were removed, be subject to double tax on the net income for his practice.

The District's Revenue Act of 1969 in proposed form contained a provision repealing this exemption, which was not contained in the Act as passed, which changed the label of the unincorporated business tax from a "franchise tax" to an "income tax". Put simply, whatever the label, the unincorporated business tax is a tax on the privilege of doing business in the District.

Second, maintaining this exemption is necessary in order to avoid the imposition of what is really a "commuter" tax, or a "reciprocal income" tax, upon one group of individuals. Put another way, maintaining the exemption is necessary in order to avoid tax discrimination against professional individuals who do not incorporate.

BENEFITS TO THE DISTRICT

While as stated, there will be significant tax incentives and advantages to incorporated professionals and their employees to be derived by the enactment of a professional corporation statute for the District of Columbia, the testimony developed that there would be benefits to the District of Columbia, and to the Federal Government, as well as to society as a whole.

The first source of revenue from passage of H.R. 10383 would be the fees to incorporate. If only a few thousand of the professionals of the District of Columbia would avail themselves of the opportunity to incorporate, the fees, it is estimated, to the District would be about $300,000.00 in 1971 or 1972, based an average corporate fee of $150.

In addition, each professional corporation will become subject to the annual payment of the District corporate income and franchise tax (District of Columbia Income and Franchise Tax Act of 1947). At present, the unincorporated professional practices are subject only to the payment of the professional license fee, while the income derived from such professional services is taxed only by the jurisdiction

of residence of the professional. If the professional practice should be incorporated in the District, the salaries of the employee-shareholders will also become subject to the District and Federal Unemployment Compensation taxes, as well as a higher total Social Security (F.I.C.A.) tax rate.

The second source of revenue would be the corporate income tax that would be forthcoming. Because corporations do not die with the death of an owner, the corporate tax would provide a greater stability in income tax revenues.

The third source of revenue would be the additional insurance premium taxes which would be collected on corporate purchases of employee benefits, such as pension plans and profit sharing plans and group life and health insurance. Since such premiums are deductible for Federal income tax purposes, corporate employers would be encouraged to provide better benefits needed by their employees.

But even if the added sources of revenue were not as direly needed by the District of Columbia, the concept of allowing professionals to incorporate would still be valid. Every state now has legislation enabling professionals to incorporate. The District of Columbia should not prohibit professionals to incorporate for to do so would risk the flight of the professional to the suburbs with result in serious loss in revenues.

SECTION-BY-SECTION ANALYSIS

Section 2—Defines the general coverage of the Act.

Section 3—Makes it clear that professionals are not required to incorporate.

Section 4—Sets forth the inter-relationships between the Act, the existing rules governing the professions, and the Business Corporation Act.

Section 5—Provides that the major activity of a professional corporation will be the rendering of professional services. However, the professional corporation may employ non-professionals (non-professionals may not render professional services), may invest its surplus funds, and may enter into partnership agreements with individuals or firms in other jurisdictions.

Section 6—The form of articles of incorporation differs somewhat from the requirements of the Business Corporation Act.

Section 7—In order to avoid artificialities and to afford flexibility in the management of the small professional corporations, the number of directors may be one or more.

Section 8—Shareholders, officers and directors of professional corporations must be licensed professionals, but shareholders need not be active. Thus retired or disabled partners can continue to have an interest in the firm.

Section 9—The names permitted to be used by professional corporations will distinguish them from commercial businesses.

Section 10—This section, and sections 12, 13, 15, 16 and 17 establish control relationships within the professional corporation which recognize that professional corporation are closed corporations which must have great latitude in placing restrictions on the transfer and voting of shares.

Section 11—Establishes that corporate identity will not protect the individual professional from liability for his own malpractice, and will not diminish the confidentiality of the relationship between the professional and the client/patient. However, malpractice by one or more professionals in a professional corporation will not subject any other professional to personal liability. The professional corporation is liable up to the full value of its assets for negligent or wrongful acts of officers, shareholders, directors, agents in rendering professional services on behalf of the professional corporation.

Section 12—Permits professional corporations to place restrictions on the transfer of shares. Recognizing that stock of professional corporations will be owned by professionals and cannot be made available to the public, the section also exempts the issuance and transfer of stock of professional corporations from the D.C. Securities law and from the Federal Securities Act of 1933. Subsection (4) is intended to minimize the disruptive effect of professional corporation shares falling into the hands of an individual creditor of a stockholder.

Section 13—This section recognizes that the rendering of professional services in D.C. should be conducted as a separate activity and not intermixed with other businesses. Out-of-state arrangements with other professionals are adequately provided for by Section 5. This provision is consistent with most state laws, which would also prohibit mergers of domestic and foreign professional corporations. The section implicitly recognizes that a single professional corporation may conduct two or more professional activities when such combinations are not prohibited by rules regulating the profession.

Section 14—Foreign professional corporations licensed in a jurisdiction other than the District of Columbia may perform professional services in the District of Columbia if they meet certain requirements by obtaining a certificate of authority under this provision.

Sections 15, 16, 17—These sections provide a method of retiring stock of deceased, disabled or disqualified shareholders.

Sections 18, 19—These are essentially administrative provisions.

Section 20—This section provides penalties—fine of not over $500—for failure to comply with the provisions of this Act.

Section 21—This section amends the District of Columbia Income and Franchise Tax Act of 1947 (D.C. Code, tit. 47 sec. 1574), in order to maintain for unincorporated professional associations the unincorporated business tax exemption which these associations presently have under that Act.

HEARING

The Judiciary Subcommittee of your Committee held a full hearing on this legislation on May 11, 1971, at which time representatives of the Bar Association of the District of Columbia, the American Institute of Architects, the D.C. Medical Society, the Washington Psychiatric Society, the D.C. Dental Society, representatives of insurance companies and of the District government, appeared or filed statements in support of the bill or its objectives.

COST

No cost to the District Government will result from the enactment of this bill. To the contrary, as shown under "Benefits to the District"

above, the District will reap incorporation fees, additional corporate and franchise taxes, and the like upon the enactment of the legislation.

CONCLUSION

It is undisputed that there is widespread interest in and endorsement of such legislation, not only in the District, but also throughout the country as is indicated by the enactment in all 50 States of similar legislation.

Your Committee considers that H.R. 10383 will be of major benefit to the professional groups in Washington, as well as to the Federal and District governments in taxes, and hence recommends the favorable approval by the Congress of H.R. 10383 as reported.

Changes in Existing Law Made by the Bill, As Reported

In compliance with clause 3 of Rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italics, existing law in which no change is proposed is shown in roman):

Section 1 of Title VIII of the District of Columbia Income and Franchise Tax Act of 1947

TITLE VIII—TAX ON UNINCORPORATED BUSINESSES

SEC. 1. DEFINITION OF UNINCORPORATED BUSINESS.—For the purposes of this article (not alone of this title) and unless otherwise required by the context, the words "unincorporated business" means any trade or business, conducted or engaged in by any individual, whether resident or nonresident, statutory or common-law trust, estate, partnership, or limited or special partnership, society, association, executor, administrator, receiver, trustee, liquidator conservator committee, assignee, or by any other entity or fiduciary, other than a trade or business conducted or engaged in by any corporation; and include any trade or business which if conducted or engaged in by a corporation would be taxable under title VII of this article. The words "unincorporated business" do not include any trade or business which by law, customs, or ethics cannot be incorporated, *any trade, business, or profession which can be incorporated only under the District of Columbia Professional Corporation Act*, or any trade or business in which more than 80 per centum of the gross income is derived from the personal services actually rendered by the individual or members of the partnership or other entity in the conducting or carrying on of any trade or business and in which capital is not a material income-producing factor.